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THE PICTURE: I've spent the last four Letters explaining why, under Dow Theory, this primary bull market is STILL INTACT. So I'm not going to waste a whole lot of time and space going over this thesis again. Suffice it to say that as long as the D-J Transportation Average holds above 709.13 (see chart below) or as long as the D-J Industrial Average holds above 1755.20, this is a bull market. A reversal to a primary bear market would require that both (not one but BOTH) Averages violate those low points

Today's business news, in general, does not make for happy reading. Two-thirds of the US is in recession, the farm depression continues, as does the oil depression. Growth in the US economy is miniscule, and quarterly corporate statements now being released are, in many cases, dismal (in the race to get lean and mean, companies are writing off everything but the kitchen sink).

With it all, the stock market is doing well. But of course, this is one characteristic of a bull market — the ability to absorb bad news while looking AHEAD to happier times. In contrast, a bear market often crashes in the face of good news -- since good news in a bear market simply produces a temporary cover which allows the sellers to exit the market.

The US stock market is now (consciously or unconsciously) adjusting to four momentous new trends. These trends are:

(1) The "internationalization" of the US. The US can no longer boast that it is a super-powerful, world-leading, insulated economy. Today the US is simply a part of the new global economy. And US business is now directly affected by, and inter-connected with, the rest of the world.

(2) The rise of mega-debts both in the US and outside it. The problem of living with and managing this debt has become a task of gigantic, almost stupefying, proportions.

(3) The acutely negative US balance-of-payments. This phenomenon is symptomatic of the demise of US world competitiveness. If the US doesn't become competitive via the will and genius of its businessmen and workers, it will ultimately become competitive via a depression, a depression which will (in the classic manner) lower US wages and prices to the point where they finally are internationally competitive.

(4) The decline of inflation. Many people take inflation's decline as a temporary phenomenon, an aberration. I'm not so sure. Massive US debt and vicious foreign competition are both powerful forces for deflation. Neither, as far as I can see, is going to "go away" in the near future.

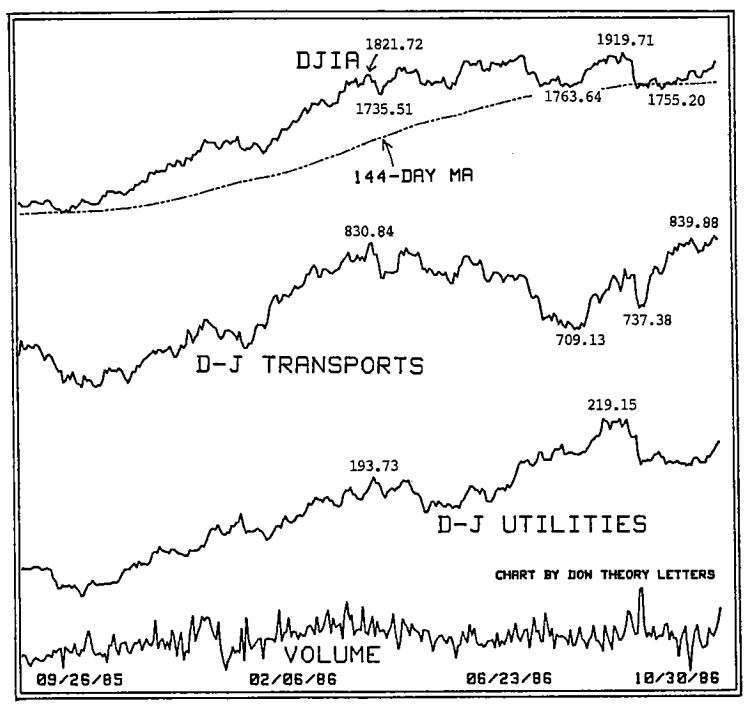
As a result of all this, we are seeing an historic UPHEAVAL in corporate America. Companies are selling off divisions, reorganizing, buying other divisions, merging, raising new money, taking in foreign capital, and in many cases being taken over by foreign capital. It's a case of get lean and mean, get taken over, or file for Chapter 11. The stock market is taking all of this into account, and so far it obviously likes it.

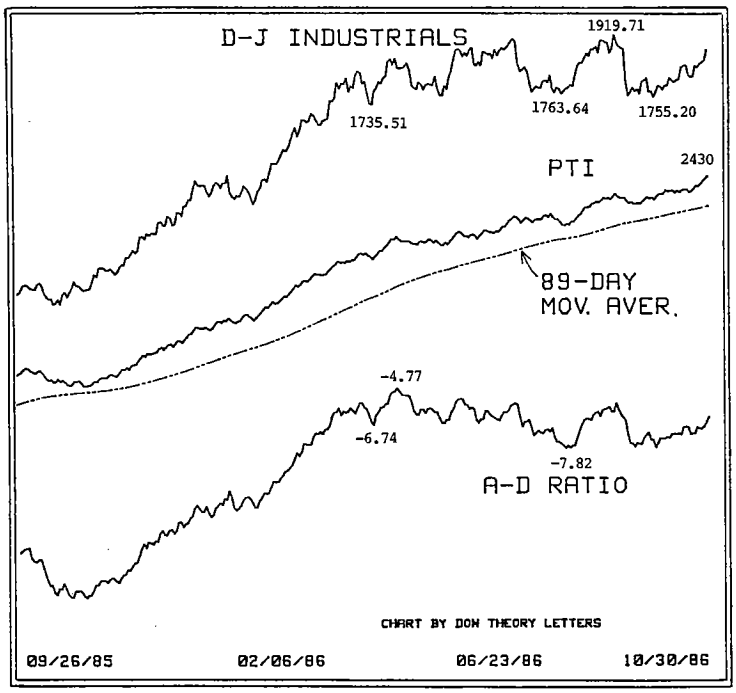
Nothing adjusts to change as FAST as the market. Built into the market is ALL the information known by anyone at any given time. Already, the markets are adjusting to the new international aspect of business. London (via "The Big Bang") has become a world marketplace literally overnight. Wall Street is sure to follow. The current proliferation of international funds (both closed-end and mutual) is a visible hint of things to come.

I expect that the NYSE will soon alter its structure to compete with London. Consider this: The NYSE now opens at 9:30am and closes at 4:30pm EST. The London Stock Exchange opens at 4am and closes at 10:30am EST. The Tokyo Exchange opens at 7pm and closes at 1am EST. Thus, the trader can now buy or sell around the clock. With the rise of the computer I expect that round-the-clock trading (even for the individual investor) will soon be commonplace. Furthermore, I expect that trading in countless foreign stocks will soon be routine. It's going to be a new world, and the new world is coming at us at the speed of an express train!

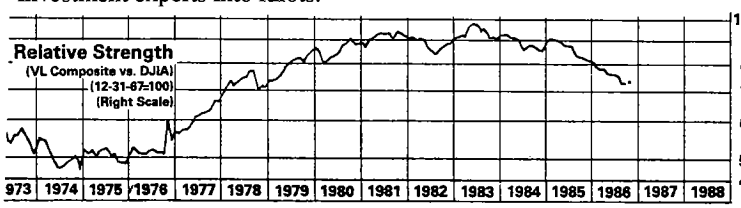
How will this new global world affect the US and you and me? I honestly don't know, but I do know two things. First, we're STILL IN A PRIMARY BULL MARKET, and that is a very obvious plus. So I'd say that it's pretty clear that the stock market likes what it sees. I also know that the need for diversification is now greater than ever. When I started in this business there were four or five places where you could put your money, and you had to figure out which of the five was "it" (i.e., stocks, bonds, real estate, cash, maybe a Swiss bank). Today your local newspaper probably contains advertisements and suggestions on two dozen places to put your money, and that's only the beginning. The possibilities today are seemingly endless.

Confusion in investing often leads to losses. So, conservative that I am, I continue to advise diversification but diversification among a limited number of items. My own preferred investment universe





consists of common stocks (including closed-end stock funds), muni bonds, real estate (i.e., my home), and gold coins. I also adhere closely to the old Wall Street adage which states, "Don't tell me what to buy, tell me WHEN to buy it." And, of course, that's just a way of saying that I'd rather buy Consolidated Sludge when the trend of the market is up (which it now is) than GE when the trend of the market is down. A big bull market turns the majority of stockholders into heroes. A big bear market turns the majority of investment experts into idiots.



I am including here a relative strength chart of the Value Line Composite vs. the Dow. Note that the general market (the Value Line is roughly representative of the general market) did better than the Dow from 1974 to 1983. This was partly because the average stock was pulverized during the disastrous 1973-74 bear market, and the years 1974 to 1983 simply saw most of these stocks return to fair value. But note that since 1983 the Dow has consistently outperformed the Value Line or the average stock. I think this action may well continue.

The reasons why it could continue, in my opinion, are that (1) the big, well-capitalized Dow stocks will be better able to compete in the international markets. (2) Everything in the US looks CHEAP to such hard-currency countries as Japan, Holland, and Germany, and high-quality foreign stocks are selling overseas at much higher multiples than the Dow stocks. Thus, I expect foreigners to be big buyers of Dow-type stocks as this bull market goes along. (3) Most blue-chip US corporations are dividend payers, and they have a habit of raising their dividends over the years. And as I have been saying in Letter after Letter, the operative concept for the rest of the 1980s, as far as investments are concerned, is going to be SAFE INCOME. And safe income is what the US blue-chip stocks tend to deliver.

Last week I received S&P's October data bank scan. I was amazed at the number of important US stocks still selling at a P/E ratio of 10 or lower, stocks such as Ford (P/E 5.2), Citicorp (6.5), Bankers Trust NY (7.6), Houston Industries (8.4), JP Morgan (8.6), AZP Group (8.6), Kaufman & Broad (9.4), Aetna Life (9.7), Travelers (9.8), Helene Curtis (8.7), and on and on. These stocks should participate in this bull market.

Other stocks I like for the rest of this bull market include such stalwarts as American Express, Phillip Morris, Borden, HJ Heinz, Exxon, Woolworth, American Brands, Merck, American Home Products, Bristol Myers, Squibb, Chesebrough Ponds, Abbott Labs, Southwestern Bell, Proctor & Gamble, Georgia-Pacific, Champion International, Allied-Signal, Kellogg, AT&T, GTE, Southern Co., Scott Paper, and well, you get the idea.

TECHNICAL NOTES: Time is running out for the bears. Many bears are still hypnotized by the parade of gloomy newspaper stories and by the frightening September market spill. But note that there was absolutely no follow-through after the panic of September 11 and 12. And since then the Averages have been pushing almost relentlessly higher.

The new record short interest on the NYSE boosts the short interest ratio to a sensational 3.10. The build-up of bears, or people who are willing to speculate AGAINST the primary trend in this bull market, has been nothing short of amazing. It is only a matter of time before the bearish element is pressed to the wall by the power of this bull market.

My Primry Trend Index (PTI) has been pushing to new high after successive high. So far, the new highs in the PTI have not been confirmed by the Dow or any of the major averages. My rule is that new highs in the PTI do not guarantee new highs in the averages, but as long as the PTI holds to a RISING TREND, the stock market is not going to turn bearish. And in the great majority of instances, a persistently rising PTI will (in time) give way to a strongly rallying stock market.

INVESTMENT POSITION: The bears (and there are a lot of them) are out or on the short side of this bull market. Ironically, many of the bulls have traded out of this market, and they too are on the sidelines, awaiting the long-promised "big reaction" -- at which point the bulls are supposed to hop in and buy. But as I've written so many times, a bull market loves to advance while taking the FEWEST number of investors with it.

And that's exactly what this bull market has been doing. Those investors and traders who thought they could outsmart the bull by trading out and then jumping in are now squirming uncomfortably as the market climbs higher -- without them. All of which, I think, underscores my basic bull market policy: in a bull market you remain fully invested. You simply STAY WITH the bull trend, buying more on reactions. This is what I have done, and I hope it is what you have done. And yes, the bull stays in the box.

WHERE or WHEN? One of the most reliable (and best-recognized) stock market occurrences since World War II is the four-year cycle. Just in case you aren't familiar with this famous cycle, I am including this M.C. Horsey monthly chart. I have included arrows showing that since 1949 this cycle has occurred with remarkable regularity.

Actually, the cycle is not that remarkable or coincidental. Many feel that it is based on the US presidential election cycle in that the market tends to top out after a president is elected. The market tops out based on the theory that once the new man is in the White House, he starts facing the real problems, and the realities of the job seldom jibe with the pre-election hopes of the electorate. Anyway, that's the theory. But as you can see, the four-year cycle doesn't always dovetail with the presidential elections; but then nothing is sure in the stock market except (as J.P Morgan put it) that "it will fluctuate."

There have been a few discrepancies in the four-year cycle, not the least of which is that occasionally the market gives us an extra downside washout within the cycle. For instance, note the "extra" reaction in 1960, which occurred between the 1957 and 1962 lows. Again, note the surprise smash in 1980 which came midway between the 1978 and 1982 bottoms.

Ah, then we come to the year 1983, a year which saw the Dow hurdle all peaks going back to 1965. Having pushed decisively above the mid-1000 level, the Dow then spurted roughly 900 points to its sensational 1986 peak of 1919.71.

So here we are in 1986, and many cycle followers are convinced that we are now way overdue for the "normal" four-year cycle drop. Furthermore, they warn, this drop should be a dusie (a word derived from the great Dusenberg autos), because "look at the 1984-86 upward spike, and a spike like that should be followed by a world-class correction."

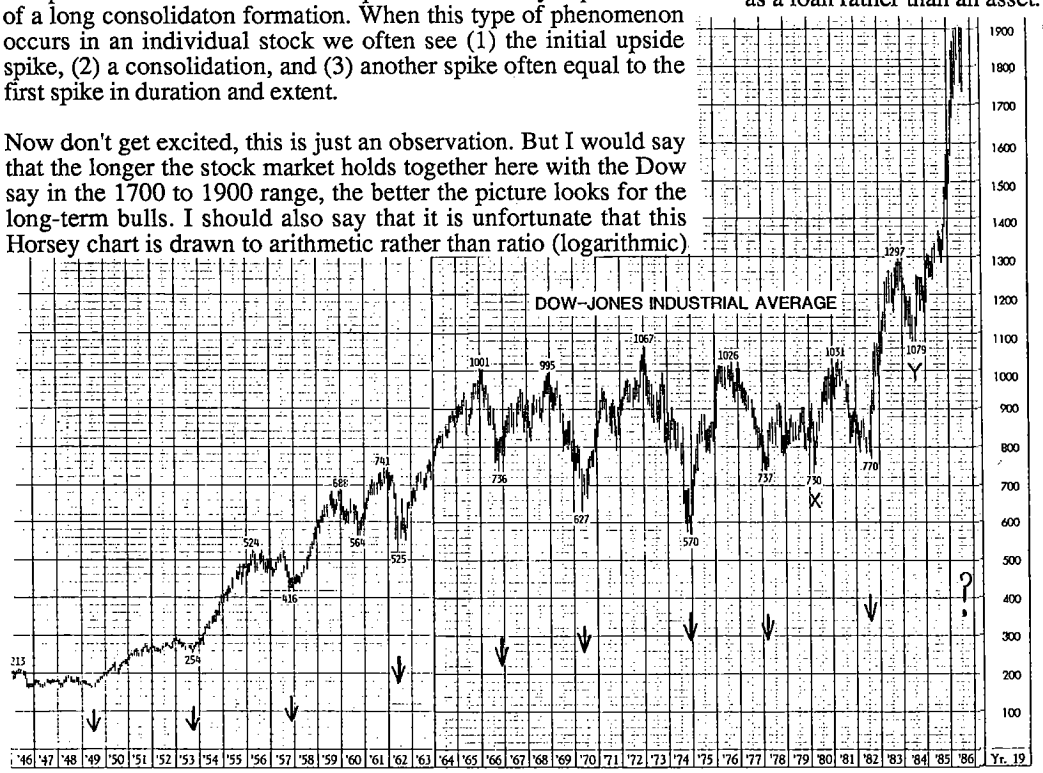
And the cycle boys may well be right. But I'm going to ask a few questions here. Following the 1974 low the identification of the cycle bottoms becomes a lot more difficult -- even hazy. For instance, isn't it possible that after the 1974 low the next cycle low occurred in 1980 (X on the chart) and that after 1980 the next cycle bottom occurred in 1984 (Y on chart). If that's what happened, then the next cycle bottom could conceivably appear in 1988 -- or if it is a bit late, in 1989.

Anyway, you see that one difficulty in using cycles is that they are open to interpretation. Just about the time the cycle study seems simple and almost automatic -- it gets complicated and anything but automatic.

Next observation: It took 18 years (1965 to 1983) for the Dow to develop enough strength to spurt decisively above the mid-1000 mark. That strength suggests that the Dow was discounting something very fundamental and very important. My own feeling is that what the Dow saw was the end of inflation, and the very beginning of the US getting down to the serious business of (1) addressing its budget deficits and (2) competing in world markets again.

The pattern that we see here in the Dow is a most unusual one. It's the spike that often forms when the price action finally explodes out of a long consolidaton formation. When this type of phenomenon occurs in an individual stock we often see (1) the initial upside spike, (2) a consolidation, and (3) another spike often equal to the first spike in duration and extent.

Now don't get excited, this is just an observation. But I would say that the longer the stock market holds together here with the Dow say in the 1700 to 1900 range, the better the picture looks for the long-term bulls. I should also say that it is unfortunate that this Horsey chart is drawn to arithmetic rather than ratio (logarithmic) scale. The arithmetic scale gives the 1984-86 price action a wild and crazy look (on arithmetic scale a rise from 1700 to 1800 appears the same as a rise from 100 to 200, although the rise from 1700 to 1800 is only 5.9% whereas the rise from 100 to 200 is 100%).



Finally, it is worth noting that the four-year cycle is now well-known and accepted by the majority of market students. The cycle has become an expected event. We watch for it; we wait for it. Now if there's anything the stock market hates, it's to be taken for granted. My, how the market despises a situation where every analyst tells us to be ready for this or that. In view of this, I guess I instinctively watch for the big fooler. And the fooler could be that the long-awaited four-year cycle washout doesn't arrive this year -- or that the cycle has already come and gone. Anyway, these are a few of my thoughts about the four-year cycle.

SHORT INTEREST: In what Investor's Daily called a "surprise 13% rise" in the short interest on the NYSE, the number of shares sold short exploded last month to a RECORD TOTAL of 436 million, up an extraordinary 49 million shares from the previous month. Last month the short interest RATIO on the NYSE rose to 3.10, a modern record as well.

What is the short interest ratio, and what is the meaning of its astounding new high? Very simply, the short interest ratio is the total of the shorts for any given period (the period the NYSE uses is from the 15th of one month to the 15th of the following month) divided by the average daily volume of transactions for the same period.

What I will now discuss has to do with straight short sales, not short sales based on arbitrage or option hedges. When an investor or trader is bearish on a stock or the market, he can express his pessimism by selling short. This is a simple act by which the seller sells a stock which he does not own (the broker loans him the certificate). The idea is to buy back the stock at a later date at a lower price. If the short seller sells IBM short at a price of say 122, and a month later he buys back (i.e., covers his short) at a price of 100, he has made a profit of 22 points minus commissions. If IBM has declared a dividend during that period the short seller must pay out the amount of the dividend (he pays the dividend to the broker who has loaned him the shares).

Unlike the situation with a stock buyer, TIME TENDS TO WORK AGAINST THE SHORT SELLER. Here's why. (1) The short seller's money is tied up in the short sale. He views the short sale as a loan rather than an asset. (2) The short seller has to pay out the dividends as each dividend is declared. (3) There is psychological pressure connected with a short sale that does not occur in the case of a stock purchase. The pressure comes from knowing that you are strictly speculating on a stock's decline whereas a stockholder feels that he is an investor who owns the shares and is collecting dividends. (4) There are no capital gains connected with short selling. All profits are considered income (although the new tax law will eliminate this handicap to the short seller). (5) Finally, there is a tendency in people to want to be bullish. But the short seller is hoping for disaster. He finds himself in the position of combing the newspapers for bad news. This goes against basic human nature, and it is therefore hard on the short seller.

So from the short seller's standpoint, time is most definitely against him. Ideally, he would like to short a stock and have it collapse the next day. The short seller gains nothing by shorting a stock and having it decline in a month or two.

In order to make real money on the short side, the short seller needs a real market smash. He needs a liquidating market -- a market that is DECLINING ON LARGE AND RISING VOLUME. In a true primary bear market sooner or later that's what you get, a market that is going down on large and increasing volume. But when you get a market in which volume tends to dry up on the downside, the short seller is in trouble. In fact, there is nothing that scares a short seller more than a market that pushes up, then backs off as volume contracts sharply.

And this kind of action is exactly what the short interest ratio measures. When the short interest builds up (as it is so dramatically doing today) and volume dries up on the declines (as it is now doing), the shorts begin to feel trapped. When this occurs within the context of a confirmed primary bull market (as now), we know that it is just a matter of time before (1) the next bull leg gets underway, and (2) the shorts start running for cover.

So that is what I believe we are seeing now. The record short position is TRAPPED within the grip of a confirmed primary bull market. The rotten business news is giving people the incentive and courage to short the market in record amounts. In the face of the grim business news and the unabated shorting, the stock market is REFUSING TO GO DOWN. Add to this our knowledge that the LONGER a bull market is held back, the more powerful the next upward leg will be, and you have the recipe for a bullish explosion waiting to happen somewhere ahead.

CONCLUSION: The longer the Averages remain in the current trading zone, the duller the volume, and the higher the short interest -- the BIGGER the next leg of this bull market is fated to be. Consequently, my advice to subscribers is: Don't be impatient, don't sell your stocks, don't believe the gloomy news you are reading in your local newspaper. This market is telling us that something very positive is fated to happen to US business during 1987 and beyond. I don't know whether that "happening" is going to be a business boom, a return to a competitive America, a bullish (maybe surprisingly bullish) result from the new tax bill, or exactly what. But the market is preparing for bullish news ahead. And we might as well prepare too. We can prepare by holding good, dividend-paying stocks.

COMPLACENCY: I have been accused of being too bullish, too optimistic, too complacent. And it's all because I follow the market. And you see, in the face of all kinds and varieties of threatening possibilities, the market has refused to turn bearish. After all, I tell my accusers, investors don't lose money when the news turns bad or when the future looks threatening, no, they lose money when the MARKET turns bearish -- and that hasn't happened yet.

But just to demonstrate that my heart's in the right place and that I respect the fears and warnings of the bears (although I believe their timing is off), I'm going to list some of the possible bearish disasters that possibly lie ahead in the possible future:

(1) A domestic banking collapse could occur. This year alone more than 100 banks have gone belly-up, and over 1,400 banks are on the FDIC's "problem" list.

(2) We could have a third-world disaster with one or more third-world nations reneging outright on their monster debts. That could easily set off problem number 1 above.

(3) We could have a S & L collapse. According to the General Accounting Office, 1,300 S & Ls are now in trouble, and that represents 43% of the total. The problem S & Ls account for a total of $100 billion in assets.

(4) The Farm Credit System could cave in. Bad loans increased $1.6 billion in the System in 1986 alone, and there is a total of $66 billion in loans in the entire System. Farm support has been growing faster than the defense budget, and that is a real horror to contemplate.

(5) Junk bonds now constitute an incredible 25% of all industrial bonds. And consider this: $25 billion of this junk came to market in 1986 alone. This new mountain of junk bonds has never been tested in a recession. The test lies somewhere ahead, and it promises to be bloody.

(6) The consumer is currently up to his neck in record debt. We could have a consumer debt collapse. The total consumer debt, by the way, is now $2.4 billion or 85% of disposable income.

(7) We could have a sudden rise in inflation, and that, of course, would usher in higher interest rates. If that occurs, gad knows what would collapse first -- but something would give, count on it.

There, how's that list for starters! And don't tell me that Richard Russell doesn't know how to be bearish. BUT, remember this, you bears. According to Dow's Theory, we're still in a bull market, and while the bull is in command, things have a way of working themselves out. Yes, problems have an uncanny way of resolving themselves happily while the bull is in command.

So it's all a matter of the primary trend, and that's a matter of timing. Sooner or later we're going to have a primary bear market, and it's going to be a beaut, a lolapalooza! I'm simply telling the bears not to jump the gun. Remember what William P. Hamilton, the great second editor of the WSJ said: "The graveyards of Wall Street are strewn with the bodies of men who were right too soon."

QUESTIONS & ANSWERS: Question: I can't decide whether to buy muni bonds as individual bonds, in the form of no-load mutual funds or as unit trusts. Can you give me some answers?

Answer: I tend to like individual top-rated (AA- or AAA-rated) bonds issued from the state where I live (of course, if you live in a state with no state taxes you can buy muni bonds from any state). Muni bonds may be purchased through your broker or through a bank. Prices may vary considerably from house to house, so it is best to check a few places.

There's nothing wrong with muni unit trusts. These are collections of muni bonds which are sold in units. Personally, I've had particularly good results with Nuveen, which specializes in munis. You can buy the muni units in any multiples, and each unit is approximately $100. The units are also sold in the secondary markets, so that you have to ask Nuveen (or your broker) what is available in both new units and older units. By the way, few brokers are knowledgeable about bonds, so you may have to find a bond-educated broker. The older muni units, which sell on a discounted basis (because the bonds have low coupons) are less likely to be called. So the ideal muni unit would be a discounted unit with a high *current* rate of return -- say a unit selling (discounted) for 70 and yielding 7.2%. By the way, unit trusts have a front-end load which is built into the price. Once you buy the units, there is no charge for selling.

I don't usually recommend no-load bond funds, and I certainly don't recommend load bond funds. Why is this? The no-load bond funds are subject to an annual management fee -- often something like 0.5% of total assets per year. But more importantly, unlike the actual bonds or the unit trusts, there is absolutely no guarantee that you are going to get your money back, no matter how long you hold the funds. The reason is that the funds can fluctuate based on how well the managers operate the fund. Example: I remember Fidelity Municipal Bond Fund selling above $14 per share (this was one of the first muni bond funds). The same fund now sells for little over $8 per share. What happened? The fund was eaten away via management fees and falling bond prices during the 1970s and early 1980s. Those who bought this fund at the highs will probably never see their capital returned. Had they bought the actual bonds or a unit trust they would get their original money back when the bonds matured at par. Put it this way, in a bear market for bonds, a no-load bond fund is a disaster. On the other

hand, those holding bonds or unit trusts know they will get their principle back -- if they wait for their bonds' maturities.

Question: Russell, what do you think of the no-load single premium life insurance policies?

Answer: They're fine, but, of course, muni bonds are more liquid. However, I just received a letter from a financial planner who is very much in favor of the no-load single premium life insurance policies. He cites these advantages of the policies (over muni bonds) and I thought they were worth listing: (1) The policies can't be called, as can muni bonds. (2) Your policy's annual rate will move with interest rates, but your principle will not decline if rates go back up, which is not true of muni bonds. (3) Policy rates are comparable to the rates on quality muni bonds. (4) You get extra life insurance. If the client is not insurable, he can be the owner and put the life insurance on his wife or some member of his family. (5) If you don't need the cash flow, you can let the cash accumulate. (6) Safety of A+ rated life insurance companies is as good or better than most munis.

Question: Please comment on the closed-end funds.

Answer: Personally, I've always liked the major closed-end funds. These are managed stock and bond funds that are closed in that when you buy one of these funds (usually listed on the NYSE) you are buying the shares from another investor in the same way that you buy GM or GE (unlike mutual funds where you are buying the shares from the fund itself, thereby increasing the fund's total assets).

Historically, the closed-end funds have almost always sold at a discount from net assets, often (in times of market disinterest) at discounts of up to 40% below net assets. At present, the funds I like are selling at 5% to 8% below net assets. These funds are Adams Express, General American Investors, Lehman Corp. and the largest closed-end fund, Tri-Continental (TY is my favorite, and it has assets of $1.3 billion and is selling at about a 5% discount from net assets). All the closed-end funds named here pay quarterly dividends plus an extra (often very large) based on profits for the year.

Recently, a number of new closed-end funds have appeared including Growth Stock Outlook Fund (GSO), Gabelli Fund (GAB) and my friend, Marty Zweig's new fund, the Zweig Fund (ZF). None of the new funds have yet established a dividend policy as far as I know, and obviously none of the new funds has a track record. All sell at a premium to net assets, so my advice is to wait before buying any of these.

One advantage of the closed-end funds over the mutual funds will become evident during the next major bear market. If people sell the no-load funds, other people will buy those shares, but there will be no forced liquidation of the closed-end funds' holdings. Not so with mutual funds. When you sell your shares in a mutual fund the fund itself redeems the shares and sends you the money. In a major bear market, if there is a huge amount of liquidation, the mutual funds may be pressed to sell some of their stock holdings in order to raise funds for redemptions. We now have around 1,200 mutual funds holding billions of dollars worth of stock. Most of these guys have never been tested in a major bear market. When the test comes, it's going to be a beaut. And I, for one, want to be in cash!

NOTES & QUOTES: The US population mix is changing drastically, according to a late Gallup poll. The number of Catholics is increasing while Protestant numbers are decreasing. Since 1947 (mainly due to high Hispanic birth rates and immigration), the Catholic population in the US has risen from 20% to 28%. Over the same period the Protestant population has dropped from 69% to 57%. And the Jews are becoming an endangered species, having dropped from 5% of the population in 1947 to 2% today. The reason for the declining Jewish percentages -- assimilation, low birth rate and intermarriage (one-third of Jews now marry "out of the faith").

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Is SDI a big boondogle? Who knows, but think about this: At least 89% of the Star Wars contracts awarded during 1985 and 1986 ($4.56 billion) went to contractors located in states with representation on the Senate Armed Services Committee (this Committee must authorize SDI funding). Almost 85% of the dollar value of the contracts went to the following five states: California, New Mexico, Massachusetts, Alabama, Washington.

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You've undoubtedly seen the pop art by Roy Lichtenstein prominently displayed in major museums. These "blown-up cartoons" go for $50,000 and up. My reaction is, "Who needs 'em?" You can buy famous hand-drawn ORIGINAL comic strips, frame them, and they make great wall art. Furthermore, they are a true piece of American history, and they are cheap. And remember, America has produced only two original art forms: jazz and comics. We just bought three original comic strips, L'il Abner, Bringing Up Father, and Nancy -- all for a total of $500! Original comic strips going back to the 1930s, '40s and '50s sell for $150 to $1,000 per panel. For information and prices write to: Artman Originals, 1620 Valley St., Fort Lee, NJ 07024; Museum of Comic Art, Comly Ave. Rye Brook, NY 10573, and Little Nemo Shop, 108-30 Ascan Ave., Forest Hills, NY 11375.

* *

Japan and the US, Comparisons: Japan with half the population of the US has 50,000 people in penitentiaries, the US has 580,000 in penitentiaries. Japan sends its kids to school 240 days a year, we send ours to school 180 days a year. Japanese kids spend 8 hours a day in school, our kids spend 4-5 hours a day in school. Japan graduates 10 engineers for every lawyer, the US graduates 10 lawyers (40,000 in 1986) for every engineer ("maybe we can litigate our way to prosperity"). The US has 96% of all the civil jury trials in the world!

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The word is that Gramm-Rudman has failed to make Congress do what it is supposed to do, and that is act responsibly on the budget In my opinion, President Reagan should have vetoed the whole budget bill and taken his stand there -- forcing Congress to make drastic cuts or throw the nation into crisis. Here's what actually happened. The lawmakers missed the April 15 deadline for coming up with a budget blueprint, and they then ignored a June deadline for implementing it. A backup plan (scheduled for mid-September) was supposed to force Congress to vote for across-the-board cuts of $19.4 billion. That plan was never even voted on. Finally, in a disgraceful effort to save face, Congress put together a phoney $12 billion package of accounting tricks that was supposed to satisfy Gramm-Rudman. "Next year," said Bob Dole hopefully, "we won't be able to avoid being serious about the budget." And the irresponsibility and deceit goes on.

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Let's not confuse carats (weight) with karats (fineness). A carat is a measure of weight, and there are 142 carats in an ounce. A karat defines the pureness of gold; pure gold is 24 karats (pure gold is considered too soft for jewelry). Legally, nothing below 10K can be called gold.

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Speaking of jewelry, the price of diamonds is firming and De Beers is about to raise diamond prices 7 percent for the second time this year. The price of D flawless diamonds (the top investment grade) crashed from a high of $55,000 per carat in early-1980 to last November's low of $7,500. Since the November low, the price per carat of D flawless diamonds has risen 70 percent to $12,000. The larger diamonds (3 carats or more) have actually become a hot item today -- with many dealers hoarding their stock. Russell opinion: diamond prices are heading up. If you're going to buy your wife a diamond, do it now!

* *

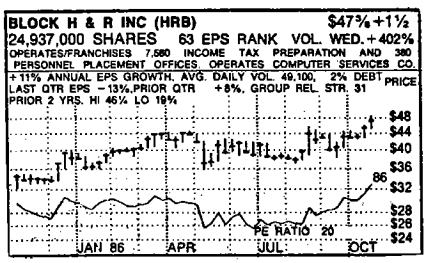
The dollar has dropped 34% against the currencies of the major industrial nations of Europe and Japan. But, says Manufacturers Hanover, that isn't the true story. Manny Hannie constructed a trade-weighted index using the US's 17 major trading partners, and using this index they found that the dollar has declined only 4% from its peak. Conclusion: In order to help our trade deficit, the dollar has to drop considerably more (and it has to drop against the countries' currencies we're actually trading with).

* *

Money magazine took a poll of their readers, and here are some of the results: 70% expect an increase in gas and oil prices next year, 43% expect inflation to increase next year, half thought interest rates would be up in '87. The average reader owed $40,500 on his mortgage, up from $33,000 last year. And 10% invested in mutual funds in '86, up from 7% in '85. Now here's an interesting one: one out of three said a lot more money would improve their sex lives. I always knew money was sexy.

* *

Is the new tax bill a "simplification" plan as it was first advertised? The market has given its answer, and you can see the answer on this chart. Here we see H & R Block hitting a new 52-week high. If the new tax bill was a true simplification, H & R Block wouldn't be hitting new highs, it would be filing for bankruptcy!



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Playing Footsie: In a few months speculators will be offered a new plaything. It will be options (from the Chicago Board of Trade) on the Financial Times-Stock Exchange 100 Share Index. This British index has been nicknamed Footsie. It is claimed that Footsie will be another cog in the internationalization of the world's stock exchanges. And it will be. My bet is that in time traders will be able to bet on the direction of all the major foreign stock averages.

* *

Expo '86 in Vancouver was great fun, and it cost Canadians $1.2 billion. But like so many other world fairs, it lost money to the tune (estimate) of $230 million.

PRECIOUS METALS: Everything, it seems is a matter of timing. Take gold. Ten years ago our government was ridiculing gold, calling it a "barbarous relic." At the same time some of us poor slobs who didn't know any better were buying gold as fast as our salary checks came in, and as history would have it, we early gold buyers were proved right and the government (as usual) was proved wrong.

But as the poet said, "There's nothing as powerful as an idea whose time has come." Here we are in 1986, and lo and behold, our own Treasury Secretary Baker calls the American Eagle gold coin "a new way to invest in America." Too bad -- as I remember it, the old way to invest was to save dollars and put 'em in the bank, but maybe Baker knows something (about banks) that we don't know. Anyway, Mr. Baker added, "gold is one of the best investments you can make if it is purchased with money that is going to be saved long-term." And I ask myself, can gold be a good buy if our Treasury secretary is telling us to buy it? And I answer, "Why not? Sooner or later somebody in Washington has to be right about something."

The gold chart below shows that gold between July and October spurted about 120 dollars. By October 6 with gold at 436 it was clear (and I said so in Letter 949) that gold had "gotten ahead of itself." My warning statement was based on the momentum index which (see chart) had rocketed far into over-bought territory.

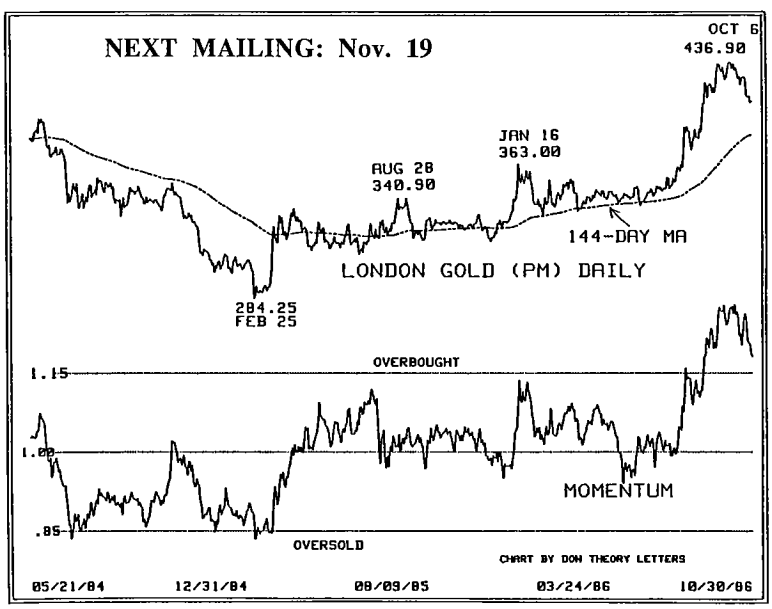
As this is written, gold has fallen to around 400, and the momentum index is still in over–bought territory but it is at least correcting. The 144-day moving average of gold now stands at 383, and it would not surprise me if gold came down to test the MA area. In fact, it would be healthy if it did.

I have recommended only one way to buy gold, and that is a program of accumulating the actual bullion gold coins. This should be done on a monthly averaging basis, and I don't care if you buy one coin a month or a hundred.

Why buy gold at all? Gold recorded a low of 284.25 back in February 1985, and I am reasonably certain that gold is in the early stages of a long-term bull market. But this early stage could last a long time, and it could be a tedious affair. Five or 10 years from now, today's $400 gold price could appear to be a great bargain, but I want to warn you that buying gold today is not for wild-eyed speculators.

That is why I have decided that the best way for my subscribers to enter the gold market is via actual POSSESSION OF PHYSICAL GOLD via bullion coins. The cheapest coins (in terms of premium over gold content) are the Austrian Coronas (.9802 ounces of gold) and the Krugerrands (one ounce of gold), both of which sell at a very slight premium over actual gold content. I recommend both coins in today's market.

Some subscribers may wonder why I have recommended the purchase of actual gold over the gold shares. The main reason I have done this is that I feel that unless you are a seasoned investor, you may get discouraged (even frightened) with buying the gold shares in this early stage of the gold bull market. In the first phase of a bull market there are many scares, shake–outs, gut-checks. And in my opinion it is easier for the average investor to hold the actual gold at this early accumulation stage than it is to hold the highly volatile gold shares.



When do I think that the gold bull market will start to move out in earnest? I believe it will happen when the bull market in stocks is near its end -- and that could be quite a while. So the idea here is to keep buying the metal and to avoid greed. Gold will move in its own good time -- it's in the bargain area now.

LATE NOTES: Ned Davis noted that I made a charting error in the last Letter (page 3 chart). The weekly A-D ratio should have been plotted to show a NEW HIGH. Therefore, both the negative volume (weekly) and the regular A-D (weekly) are at new highs for this bull market. This makes the technical picture even stronger than I had shown it. I might add that I've never seen a bull market end with the weekly A-D at a new high. ... With the October 31 closing of 1877.81, the Dow has closed HIGHER seven out of eight weeks. Furthermore, the PTI on October 31 was at a record high of 2432. That makes it six weeks in a row the PTI has closed at record highs. With such an extended string of new highs in both the Dow and the PTI, it would seem the market is now overbought. Therefore, a decline or consolidation at any time should not be unexpected. ... On another subject, my chart of the dollar index strongly suggests that the dollar may have traced out an important BOTTOM.